Financing Confederation

Today and tomorrow

Summary and conclusions

Economic Council of Canada

1982

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This report reflects a consensus of the Economic Council of Canada. However, dissenting comments by Mr. Lortie appear after Chapter 11.

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PREFACE

For some time, the Economic Council of Canada has been studying the federal-provincial fiscal arrangements. The report that we have prepared on this subject focuses on long-term solutions to the problems associated with them. While it emphasizes solutions for tomorrow, the report does not avoid the issues that are under discussion today by the federal and provincial governments during their current quinquennial review of these arrangements. Many of the issues in their negotiations have considerable bearing on the long-term solutions that are being proposed.

Since completion of the research for this report, and even before that, the Council has been endeavouring to determine how best to disseminate its findings in the hope that they might contribute to policy making and to public understanding of these issues. With governments due to finish their quinquennial review of the arrangements this year, it is felt that we must get our analysis and recommendations into the public domain as soon as possible.

For this reason, the Council has decided to publish its report in two stages. This report, being the first stage, includes Chapters 1 and 11 of our final report. Chapter 1 outlines the setting and the issues that are important to the fiscal arrangements; Chapter 11 summarizes the entire report and presents the Economic Council's conclusions and recommendations. At the second stage, the complete report will be released. The time required to edit, translate, and produce it in its entirety, however, simply will not enable us to make it available in published form before early February.

When reading this report, it should be remembered that there is considerably more analysis of the issues and recommendations in the final report. Chapters 1 and 11 may not fully reflect the treatment of issues in the complete report.

1 INTRODUCTION

THE OBJECTIVES

Every five years, the federal and provincial governments undertake a review of the federal-provincial fiscal arrangements. This quinquennial review has taken place ever since the practice became established some 40 years ago when intergovernmental agreement was reached on one of the forerunners of the present arrangements, the Wartime Tax Agreements.

Currently, the federal and provincial governments are again in the midst of such a review. While numerous and varied financial links exist between the federal and provincial governments, at issue is primarily a federal statute entitled "The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977" (hereafter referred to as the Fiscal Arrangements Act). The key elements of this legislation are the provisions relating to the Tax Collection Agreements, the Equalization Program, and Established Programs Financing (EPF). Normally the review would be completed prior to March 31, 1982, when the terms of the Equalization Program expire. New legislation would then be passed by Parliament covering these programs for another five-year period.

This review of the fiscal arrangements and, of course, the arrangements themselves are of paramount importance to all Canadians. The very magnitude of the resources involved in the programs underlines their significance. In 1980/81, the federal government will transfer $13 billion in cash to the provincial governments in keeping with the provisions of a variety of programs, which in total account for about 20 per cent of total federal expenditures. These cash transfers will constitute as much as 50 per cent of the total revenues in the Atlantic provinces (see Table 1-1). Of this total, some $10 billion will be paid out under programs covered by the Fiscal Arrangements Act. In addition, the tax transfers that the provinces have accumulated over the years in partial payment for joint federal-provincial programs will have a value of approximately $5 billion in 1981/82.

Table 1-1

Federal Transfers[1] to Provincial Governments as a Proportion of Total Gross General Revenue, Canada, Selected Years, 1952-80

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia
					(Per cent)					
1957	52.7	55.6	46.6	45.7	13.0	17.6	47.1	28.4	21.7	28.2
1962	59.9	51.7	44.2	46.3	27.7	22.1	30.5	25.6	22.0	18.6
1967	61.7	57.1	54.6	48.5	23.7	18.1	34.0	25.7	20.3	15.5
1972	52.3	50.1	42.0	43.4	21.4	19.3	32.3	37.2	20.3	15.7
1977	47.1	54.8	46.6	47.4	23.5	17.6	34.9	18.2	9.7	16.4
1980	47.7	52.8	45.8	43.9	21.6	17.3	37.6	16.9	7.7	16.1

1 Excluding tax transfers.
SOURCE Based on data from Statistics Canada.

Quite apart from the magnitude of the funds involved, the fiscal arrangements reflect very significant characteristics of the economic and political environment in Canada. Some of these characteristics include:

- the major scale of operations by the federal and provincial governments relative to the economy as a whole;

- the autonomous and independent roles played by the federal and provincial governments in the determination of an extensive and complex range of social and economic programs; and

- the extraordinary degree of interdependence among governments, with joint policy making and shared responsibilities being an integral aspect of many of these programs.

Despite the significance of the fiscal arrangements, this topic remains complex and not well understood. One important objective of the Economic Council in publishing this report is to help Canadians to become better informed about the nature of the programs covered by these intergovernmental arrangements and to be more aware of the important part they play in their daily lives.

In analysing the fiscal arrangements, the report focuses on the three major programs under the Act - the Tax Collection Agreements, the Equalization Program, and Established Programs Financing. It does not analyse in detail other important federal-provincial fiscal programs that do not come under the

Act - for example, the Canada Assistance Plan, programs under the federal Department of Regional Economic Expansion, and those relating to manpower training, to name but a few. It should be noted, however, that fiscal programs beyond the scope of the Act - notably the Canada Assistance Plan - have been important in past reviews of fiscal arrangements.

The focus of this report has been confined to the programs under the Fiscal Arrangements Act for a number of reasons. These programs account for 75 per cent of all federal-provincial transfers. They are also the ones that are currently under review by the federal and provincial governments in their negotiations concerning fiscal arrangements.

This report is restricted to issues pertaining to federal-provincial fiscal arrangements and ignores those involved in local government financing and in relations between local governments and other levels of government. Many of the same issues that arise in federal-provincial fiscal matters also arise in arrangements between provincial and local governments. We are not asserting that the latter issues are unimportant; they are simply outside the focus of the present report.

In addition to its informational function, the report is also intended to provide a useful input for those in government who are involved in the policy-making process. While extensive revisions were made in the programs under consideration in 1977, it is our underlying conviction that changing circumstances and practical experience dictate the need for further substantial reshaping of the policies governing these programs. It would seem premature, however, to incorporate many of these major changes in the upcoming revision of the legislation because the issues that need to be resolved are complex, and major gaps exist in the relevant information and analysis.

In our view, policy makers should press forward as quickly as possible with studies and discussions as a prelude to major changes in the system, at least before the next set of federal-provincial negotiations in 1987. The adoption of proposals designed to implement major change requires a wide degree of public and government support, which can only be achieved through extensive and thorough public examination and debate. High priority should be given by those responsible for the formulation of policy to examination of the long-term issues related to fiscal arrangements.

In brief, the main goals of this report are:

- to examine and determine the appropriateness, under current and prospective circumstances, of the tax and transfer

arrangements between the governments of Canada, the major programs being the Equalization Program, Established Programs Financing, and the Tax Collection Agreements;

- to consider some long-term, fundamental adjustments to the arrangements, along with some modifications for immediate implementation;

- to promote an understanding of these arrangements and issues by Canadians generally.

THE SETTING

The background behind the development of these programs is a complex history of the various precursors of the programs now grouped under the Fiscal Arrangements Act. While the specific historical details are outlined more fully later on in the report, a brief portrayal of the development of these arrangements will provide a setting and help the reader to gain initially some understanding of their nature.

From very early on in Canada's history, the need emerged for co-operation and consultation on fiscal matters between the federal and provincial governments. A crucial aspect in reaching agreement on Confederation was the federal government's commitment to make financial subsidies to the provinces. They were designed to replace the taxing powers lost by the provinces under the division of powers in the British North America Act (BNA Act). Moreover, these subsidies were the subject of considerable debate and adjustment during the first years of the new nation.

While these early instances of intergovernmental liaison on fiscal matters were important, the major elements of the present system of fiscal arrangements evolved with the growth in government activities. Beginning with the Depression of the 1930s, there was increasing government intervention in economic and social affairs. These new economic and social responsibilities reflected a greater commitment to "full" employment, economic growth, trade liberalization, regional development, and infrastructure investment. Inevitably, the assumption of these responsibilities led to a growing need for intergovernmental liaison and joint policy making on fiscal matters.

A major factor in the development of the fiscal arrangements was the Report of the Royal Commission on Dominion-Provincial Relations [the Rowell-Sirois Commission][1] in 1940. In response to the new responsibilities of governments and the economic dilemma of the 1930s, the Commission recommended that

the federal government take over the debts of all the provinces and the responsibility for unemployment relief. In addition, it advocated that the federal government pay a "National Adjustment Grant" to the less fortunate provinces in order to give them the opportunity to bring standards of services in those provinces up to the national average. In return, the Commission recommended that the provinces give up their claim to several taxes, including personal income tax, direct taxes on corporations, and succession duties.

Despite the fact that the report of the Commission was rejected by three provinces, the exigencies of the Second World War enabled the federal government to persuade the provinces to surrender their right under the Constitution to levy personal and corporate income taxes in return for per capita cash transfers from the federal government, which became known as "tax rentals." Ever since then, the federal government has collected personal and corporate taxes in most provinces. For the past several years they have been collected on behalf of the provinces themselves. Also, for many years there have been agreements aimed at the harmonization of federal-provincial taxation.

The recommendations in the Rowell-Sirois report for a national adjustment grant took longer to implement. Even the tax rental agreements in effect during and after the war embodied, to some extent, the rationale behind the Rowell-Sirois proposal, however; and with the adoption of the Equalization Program in 1957 the concept of equalization advocated in the Commission's report was formally established.

The other important elements now under the fiscal arrangements - the Established Programs Financing arrangements involving health and postsecondary education - were primarily developed as part of the social system between the late 1950s and the early 1970s. Prior to 1977, programs that now come under Established Programs Financing were financed through a sharing of costs by the federal and provincial governments. This type of shared-cost grant has a long history, especially in the areas of transportation, agriculture, and pensions. It was in the postwar period, however, that the federal government took steps to establish the majority of shared-cost programs in the areas of hospitalization, medical care, and postsecondary education, despite questions concerning its jurisdiction in these areas. In 1977, these shared-cost programs in health and postsecondary education were converted into a form of block grant and grouped together under Established Programs Financing. In contrast to other shared-cost programs, health care and postsecondary education were designated as mature or

"established" programs that, as such, required few federal conditions to govern their operations by the provinces.

THE ISSUES

The Council has found many attractive features about the present fiscal arrangements. In general, there are more aspects of the arrangements worth preserving than modifying. Still, a number of issues have recently been raised that bring into question fundamental elements of the existing arrangements. In this section, we shall describe these issues, as lawyers say, "without prejudice," in order to establish at the outset the parameters of the debate on the fiscal arrangements. In the body of the report, we shall evaluate many of the issues and identify those which deserve attention.

The Division of Responsibilities among Governments

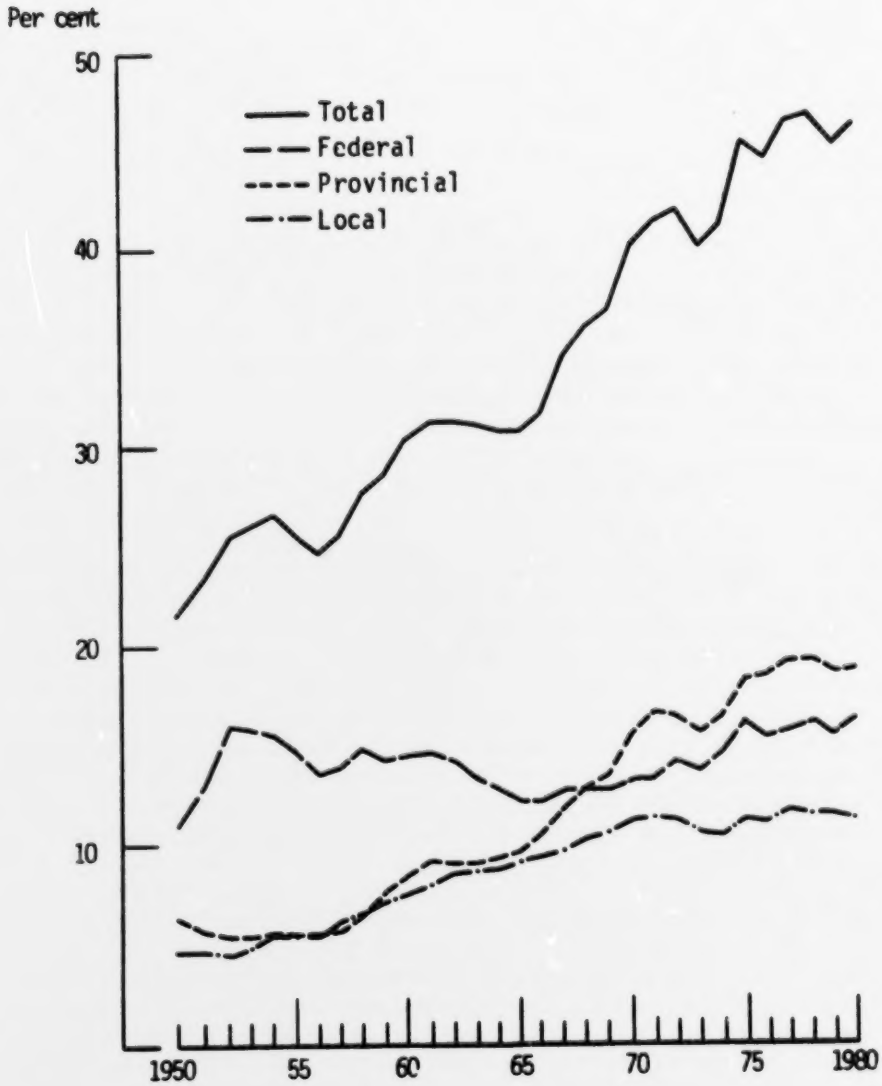
The debate on this issue relates to the interdependent character of the fiscal arrangements identified earlier. Some see the sharing of responsibilities in the programs that form part of the fiscal arrangements as a positive attribute. From this viewpoint, it is argued that federal and provincial interests need to be further integrated to improve joint policy making in the fiscal arrangements. At the same time, others allege that there is a fundamental flaw in such interdependence because the public cannot easily identify the responsibilities of each government; thus those who are supportive of this view advocate substantial "disentanglement" of federal-provincial responsibilities and programs. The main principle behind disentanglement is often suggested to be that each government should match its own revenue-raising capacities with its expenditures.

The Size of Government

Governments at all levels carry out an extensive and complex set of activities in our society. For the past five years, total federal, provincial, and local government expenditures have amounted to approximately 40 per cent of gross national product (see Chart 1-1). To some, the very magnitude of government activities acts as a deterrent to the efficient operation of the Canadian economy. An effort to reduce the overall size of government, in line with this view, could adversely affect the social and economic programs established as part of the fiscal arrangements. The option open to those who support this approach is either to reduce or to terminate some of the programs.

Chart 1-1

Federal, Provincial, and Local Government Expenditures[1] as a Proportion of Gross National Product, 1950-80



1 After cash transfers among all governments.
Source Statistics Canada, National Income and Expenditure Accounts, Cat. 13-201, various issues.

The Setting of Economic and Social Policy Priorities

An important, on-going issue with respect to the fiscal arrangements is that of which level of government - federal or provincial - should take the lead in establishing priorities for economic and social policy in Canada. The review of the fiscal arrangements at five-year intervals provides a forum in which each government tries to set priorities for social and economic policy in consultation with other governments. As a result, the fiscal arrangements have a great deal to do with issues that basically have to do with political power and the role that each level of government is perceived by the public to play in the delivery of social and economic programs.

The Effective Provision and Financing of Public Services

Many Canadians believe that there are inefficiencies in the provision and financing of public services in Canada. This broad issue is specifically applicable to the programs carried out under the Fiscal Arrangements Act. Some people stress a need for greater provincial control over these programs; others call for a more direct role by the federal government in the maintenance of national standards.

The Stability of Government Revenues

One of the goals of the fiscal arrangements is to provide a measure of stability to provincial government revenues. The importance of the fiscal arrangements to some of the provincial governments underlines the need to require that consultations be undertaken before any changes are made in these arrangements. The present Fiscal Arrangements Act, like its predecessors, already contains provisions of this sort; however, some argue that no amendments to the fiscal arrangements should be made without notification well in advance. This would be done only in consultation with the provinces. Thus provincial governments would have greater protection against an unanticipated loss of federal transfers.

The Conditionality or Unconditionality of Programs

In the Established Programs Financing arrangements that were instituted in 1977, a major change was made with regard to financing medical care, hospital insurance, and postsecondary education. As noted earlier, prior to 1977 these programs were financed by the federal and provincial governments on a shared-cost basis, with the federal government linking its contributions directly to the costs of specific services. In 1977, under Established Programs Financing, the federal

transfers for these programs became block grants, with fewer strings being attached to the type of services the provinces ultimately provided.

The advantages and disadvantages of each system of financing still remains an issue today. Some people contend that the unconditional nature of the current arrangements does not ensure the maintenance of national standards in health services or the adequate financing of postsecondary education. Others maintain that the provinces are in a better position than the federal government to determine the kinds of health and postsecondary education programs appropriate for their citizens and thus there should be fewer strings attached to federal transfers.

The Equalization Program

The rapid increases in world petroleum prices over the past decade have led to a series of amendments and modifications to the formula for calculating federal transfers or entitlements to provinces under the Equalization Program. The massive rise in the oil and gas revenues of the producing provinces had threatened to increase drastically the federal liabilities under the program. These increases have only been modified by amendments to the Act limiting the amount of oil and gas revenues to be taken into account for purposes of the equalization formula. With oil and gas revenues accruing largely to the western provinces, the federal government would have been required to make large payments to the poorer provinces, even though it did not share significantly in those increased revenues. A number of amendments to the Act have been adopted to limit the obligations of the federal government in this respect.

The principal problem with the Equalization Program concerns its present lack of direction. Evidence of this is provided by the ad hoc changes that have been made in the program in recent years and the variety of proposals advanced for reform. Perhaps more importantly, the underlying purpose of the program has been called into question. It has been argued, for instance, that the regional orientation of the transfers in the program has adverse effects on the efficiency with which resources are allocated in our economy and that the system should be replaced by a "people-oriented" transfer program, such as some form of guaranteed annual income. There is clearly no agreement at present on the underlying philosophy of the Equalization Program.

It should also be noted that the Equalization Program is not the only program in the Fiscal Arrangements Act whose specific

objective is to raise the revenues of "have-not" provinces. As already indicated, conditional grant programs for health and higher education were replaced in 1977 by a block grant of an equal per capita amount for each province. Some have proposed that these separate programs be combined with the Equalization Program into one integrated program, since they share the same objective.

Co-ordination, Stabilization, and Harmonization

While there may have been less emphasis recently, in the prevailing economic milieu, on the use of fiscal policy to influence economic performance, the need for co-ordinated stabilization measures has not disappeared. Since the 1950s there has been a relative shift of fiscal power from the federal government to provincial governments. Indeed, as Chart 1-1 shows, the provincial share of revenues after transfers has increased steadily since that time. Some observers contend that the ability of the federal government to implement effective economic stabilization policies has been seriously undermined as a result of this development. Conversely, there are others who argue that provincial governments lack the power necessary to carry out selective stabilization policies that fit the needs of each region.

Another long-standing debate of importance to fiscal arrangements concerns tax harmonization. Since 1947, there has been a trend away from the centralization of personal and corporate income taxes that existed during the war to a much more flexible sharing of income taxes among federal and provincial governments. Tax harmonization is primarily achieved today through the Tax Collection Agreements, as part of the fiscal arrangements. At issue are rules to prevent "double" taxation of income and other steps to avoid a return to the "tax jungle" of the 1930s. In this connection, the recent intergovernmental discussions on a "Code of Conduct" are noteworthy. It would establish broad principles of intergovernmental co-operation on tax and expenditure policies.

Welfare Dependency and Equalization

A question of dominant interest in assessing the present Equalization Program concerns the possible conflict between the goal of national economic efficiency, on the one hand, and the regional effects of intergovernmental transfers, on the other. It has been alleged by some economists that the Equalization Program prevents the efficient allocation of resources in the economy because it leads to capital and labour being retained in areas where their productivity is low.

It is also maintained that the Equalization Program and other transfer programs have led to an unhealthy dominance of government expenditures in the economies of the "have-not" provinces, with some of the provinces becoming more and more dependent on those transfer systems - resulting in what can be called "welfare dependencies." It is alleged that "have-not" provinces are encouraged as a result to enact legislation that is detrimental to their long-term economic well-being. It is thought that the incentives embodied in the transfer systems are such that provinces do not bear the full political and economic costs of legislation that maintains regional disparities.

The Intergovernmental Review

Canada is characterized by a high degree of federal-provincial consultation and co-operation in a wide range of policy areas. The intergovernmental review of the fiscal arrangements at five-year intervals is one of many examples of such inter-governmental liaison. Important questions have been raised about the level of openness, participation, and accountability, as well as the effectiveness of decision making, in federal-provincial processes of this sort. With the nature of Canadian federalism under scrutiny during this period of constitutional debate in Canada, the appropriate role and power of governments is also at issue, especially in the area of federal-provincial relations.

THE PROBLEM OF A FISCAL IMBALANCE

In the current negotiations on fiscal arrangements, perhaps the most controversial issue is the question of a "fiscal imbalance." Mr. MacEachen, the federal Minister of Finance, has maintained that the existence of such an imbalance is evident from the large and persistent deficit of the federal government compared with the surplus of the provinces as a whole.[2] The importance of this argument for the negotiations is paramount, since it constitutes a large part of the rationale behind the federal government's stated intention to reduce the amount of net federal transfers to the provinces by $1.5 billion over the next two fiscal years. While the rationale behind a reduction in federal transfers will be discussed later in the report, the very magnitude of the proposed reduction requires that the issue of "fiscal imbalance" be addressed in some detail at the outset.

The balance between the financial capacities of governments and the expenditures required to meet constitutional responsibilities appears to be a persistent source of contention in most federal states; Canadian experience is no exception.

This issue arises in two contexts. The first refers to the differing financial capacities of provincial governments to carry out the same constitutional functions. Because these differences in financial capacity all affect the same level of government, the problem is often referred to as one of "horizontal" fiscal imbalance. This problem is addressed in Canada by the federal Equalization Program.

The budgetary situations of federal and provincial governments over the past two decades have focused attention on a second type of possible fiscal imbalance - an imbalance between the federal government, on the one hand, and the provincial governments collectively, on the other. Because this issue relates to the financial capacities and the responsibilities of different orders of government in our federal system, it is often referred to as one of "vertical" fiscal imbalance.

This issue of vertical fiscal imbalance is one of long-standing concern. Thus, in the 1960s provincial governments argued that the most rapid growth in public expenditures was occurring in areas of provincial constitutional jurisdiction, such as health and education, while provincial revenue sources were less responsive to economic growth than those of the federal government. The alleged result of these different forces was a persistent tendency for the federal government to incur budgetary surpluses, while provincial governments experienced budgetary deficits. Provincial governments proceeded to argue that there was a limited fiscal "pie" to be divided up among all governments and that in order to rectify this fiscal imbalance, tax revenues should be transferred from federal to provincial governments. The federal government, in turn, replied that provincial governments should raise their own tax rates to finance their expanding services. While the arguments of the provincial governments were not conceded, it is nevertheless worth noting that transfers of federal income tax revenues were made in the 1960s as part of the federal contribution to shared-cost programs.

In more recent years, it has been the turn of the federal government to claim that there is "vertical" fiscal imbalance in Canada. For the first time in the history of the Fiscal Arrangements Act, the federal government is approaching renewal of the Act in 1982 with the view that federal transfers to provinces should be reduced.

In analysing the question of an imbalance between levels of government in Canada, a distinction should be made between a long-term economic problem that requires substantial <u>structural</u>

adjustment and a problem that needs to be resolved through political decisions with respect to social policy.

In order to say that there is a "structural" economic problem relating to a fiscal imbalance, it must be argued that one of the levels of government does not have access to the revenues required to fulfill its obligations to the citizens of the nation under the Constitution. There is no question, however, that both levels of government in Canada today have access to all major revenue sources. Thus the correction of a fiscal imbalance at one level of government is primarily a matter of raising taxes, restraining expenditures, or both. In Canada, then, the issue of a fiscal imbalance can hardly be called a long-term "structural" economic problem.

While this imbalance may not be structural, it does not mean that the issue of an imbalance does not require hard political and social choices. It is hardly comforting for policy makers to hear that all the particular government has to do to eliminate a deficit is to reduce its expenditures or increase taxes, or both.

In this context, there remain some difficult issues to be examined when discussing the question of fiscal imbalance. There is, for example, the issue of whether the fiscal arrangements have been a cause of the deficit position of the federal government or whether it would be appropriate to reduce federal transfers to the provinces in order to cure the imbalance. Some people argue that the programs in the fiscal arrangements were conceived under much better economic circumstances than exist today, particularly at the time of the 1972 and 1977 negotiations. For this reason it is said that the amount of federal transfers to the provinces should now be re-examined.

To determine the validity of these claims, it is helpful to review the nature of the federal deficit and its causes. In general, a deficit arises when total expenditures exceed total revenues at any one point in time. As such, any program that contributes to the expenditures of the federal budget must bear some responsibility for the current federal deficit.

What role have federal transfers to the provinces played in the expenditures of the federal budget? Table 1-2 shows the percentage distribution of federal current expenditures, excluding interest payments, for the years 1960 to 1981, together with the surplus or deficit for each year. While federal transfers to other levels of government account for a large portion of total federal spending (about 25 per cent),

there is no reason to suggest that these expenditures played a particularly significant role in the escalating federal deficit during the period 1975-81, as set out in Column 6 of Table 1-2. Federal transfers to other levels of government accounted for a roughly constant proportion of total federal spending (excluding interest payments) throughout this period. In fact, there has been little change in the shares of any one of the broad expenditure categories as a proportion of total federal expenditures over this period.

Table 1-2

Distribution of Federal Expenditures, Excluding Interest Payments, by Type of Expenditure, Canada, 1960-81[1]

	Goods and services	Transfers to persons	Transfers to governments	Other	Total	Federal surplus or deficit (-)
			(Per cent)			($ Millions)
1960	42.1	34.2	17.2	6.5	100	-229
1961	42.4	32.9	18.5	6.2	100	-410
1962	42.3	33.2	17.9	6.5	100	-507
1963	40.6	33.1	18.2	8.0	100	-286
1964	40.4	32.9	18.4	8.3	100	345
1965	39.6	32.3	20.0	8.1	100	544
1966	40.0	30.4	20.4	9.3	100	231
1967	38.4	31.4	21.5	8.7	100	-84
1968	37.6	31.9	23.0	7.5	100	-11
1969	37.2	31.6	23.9	7.3	100	1,021
1970	35.2	31.4	26.3	7.2	100	266
1971	33.3	31.4	29.0	6.3	100	-145
1972	31.6	35.9	26.4	6.1	100	-566
1973	31.7	36.5	25.1	6.7	100	387
1974	29.7	34.9	24.7	10.7	100	1,109
1975	27.2	34.6	25.0	13.2	100	-3,605
1976	29.3	34.9	25.8	10.0	100	-3,391
1977	29.7	34.9	26.5	8.9	100	-7,303
1978	29.0	35.4	26.3	9.3	100	-10,654
1979	29.2	33.6	26.9	10.3	100	-9,213
1980	27.4	33.1	25.6	14.0	100	-10,697
1981	27.1	32.2	25.8	14.9	100	-6,674

1 Data are actual for 1960 to 1980 and projected for 1981.
SOURCE Based on data from Statistics Canada.

If expenditures, including those relating to federal transfers to the provinces, are not a "cause" of the deficit, there must be reason to seek an explanation on the revenue side. While federal government expenditures, as a whole, remained around 21 per cent of gross national expenditure from 1975 to 1981, total federal revenues declined gradually from 19 per cent of GNE in 1975 to 16 per cent in 1978 and 1979. It is clear, therefore, that the emergence of an escalating federal deficit in the latter part of the last decade is more appropriately associated with declining federal revenues than increasing federal expenditures.

What are the main causes for this decline in federal revenues? To a large extent the change in the federal deficit position over the 1975-80 period can be attributed to weakness in the economy. Poor economic performance tended to reduce revenue collections, while it led to higher expenditures on such programs as unemployment insurance. This relationship between economic performance and the deficit is often described as the result of certain automatic fiscal stabilizers built into federal economic policies. According to Economic Council estimates based upon the CANDIDE econometric model,[3] more than 60 per cent of the federal deficit in the current year may be attributable to the fact that the economy is not operating at its full-employment potential.

Aside from the effects of poor economic performance on the federal deficit, the federal government has significantly reduced its flow of revenues by the introduction of a variety of discretionary tax measures. The cumulative effect of these measures was to reduce by more than $14 billion the revenue that would otherwise have been collected by the federal government in 1979. Also, the effect of indexing personal income tax, as introduced in 1973, was to decrease federal revenues from this source by some $6 billion in 1979.[4]

To present a fair appreciation of the deficit and its causes, it is necessary to examine the effect of one other expenditure program. The federal policy of subsidizing oil imports through the Oil Import Compensation Program has cost the federal government, on average, over $1 billion for each year since 1974. Prior to 1980, however, these expenditures were generally more than offset by the combined revenues from the oil export tax, the petroleum compensation charge, and the excise tax on gasoline. It was only in 1980, as indicated in Table 1-3, that the balance on the federal government's petroleum-related accounts turned substantially negative.

Table 1-3

Petroleum-Related Federal Revenues and Expenditures, Canada, 1973-80

	Revenues			Expenditures		
	Oil export tax	Gasoline excise tax	Petroleum compensation charge	Oil import compensation payments	Syncrude levy	Balance of petroleum-related accounts
			($ Millions)			
1973	83	-	-	-	-	83
1974	1,618	-	-	886	-	732
1975	1,121	222	-	1,692	-	-349
1976	700	634	-	1,054	-	280
1977	476	585	-	922	-	139
1978	294	567	37	644	9	245
1979	718	428	318	1,134	296	34
1980	850	441	766	2,989	956	-1,868

SOURCE Based on data from Statistics Canada.

It is important to stress that the federal government has taken action that will significantly reduce the cost of the Oil Import Compensation Program and greatly increase its flow of revenues from taxes imposed on the petroleum sector. One of the effects of the National Energy Program, along with the new energy pricing agreements reached with the oil- and gas-producing provinces, is to substantially improve the budgetary outlook for the federal government in this decade.

The fiscal positions of the provinces also have to be considered in any examination of the existence of vertical fiscal imbalance. While there are prospects for substantial improvement in the fiscal position of the federal government, the majority of provincial governments can expect to experience increased deficits over the next five years. The extent to which this is so is particularly clear when we distinguish the current and future fiscal prospects of Alberta, British Columbia, and Saskatchewan from the rest of the Canadian provinces. If the oil and gas revenues, which are now largely accruing to these three western provinces, are removed from the provincial sector as a whole, the effects of this distinction become apparent. Subtraction of the estimated oil and gas royalties from the provincial sector results in a projected provincial deficit of considerable magnitude - increasing from $3 billion in 1981 to $9 billion in 1986.[5] These estimates provide an approximate indication of the fiscal situation to be faced over the next decade by those provinces which do not produce oil and gas, but they do not take into account the differences between provinces. The fiscal positions of some of the poorer provinces will be even more seriously affected than these estimates indicate.

In light of this analysis of the federal deficit as it relates to the question of vertical fiscal imbalance, the Council sees no compelling argument in support of the federal government's proposed reduction in net transfers to the provinces. The proposed reduction is nevertheless discussed later in the report in terms of specific programs under the fiscal arrangements, and our recommendations follow from that analysis.

OUTLINE OF THE REPORT

Briefly summarized, the contents of the remainder of this report are as follows. Chapters 2 through 5 treat issues relating to the Equalization Program. The program's objectives, and performance in relation to those objectives, are assessed. Alternative principles that could be used as a guide for the program are also evaluated. Since the equalization of resource revenues or "rents" accruing to the provinces has led to

fundamental problems in the program, the matter of the appropriate treatment of these revenues is discussed at length. Chapters 6 and 7 deal with the Established Programs Financing arrangements and with the future of federal transfers in the related areas of health and education. Chapters 8 and 9 concern two issues of economic policy co-ordination that are affected by the fiscal arrangements: the conduct of stabilization policy, and the objectives of taxation and fiscal harmonization. Chapter 10 examines questions about the federal-provincial process by which the fiscal arrangements are reviewed every five years. Chapter 11 presents the conclusions and recommendations of the report.

11 THE ISSUES: CONCLUSIONS AND RECOMMENDATIONS

THE NEED FOR CHANGE IN THE FISCAL ARRANGEMENTS ACT

An argument could be made for little change in the 1982 Fiscal Arrangements Act in order to minimize federal-provincial tension. The renewal of the legislation follows a period of considerable friction in federal-provincial relations generated by controversy over major constitutional and energy issues. It might also be argued that because far-reaching reforms were made only in 1977, further radical change is inappropriate at this time.

In contrast to these arguments, it can be contended that further change is inevitable because of the dissatisfaction of both levels of government with the current fiscal arrangements. Thus, it may be claimed, the major change in the 1977 Fiscal Arrangements Act - the replacement of shared-cost programs in health and higher education by block funding in the Established Programs Financing arrangements - has only led to further controversy. Because of its evident dissatisfaction with the operation of the new block-funding scheme, the federal government appointed a Royal Commission on Health Services (chaired by the Honourable Emmett Hall) to examine its effects on the provision of health care.[1] As part of its overall strategy to reduce its budgetary deficit and shift its spending priorities towards economic development, the federal government has indicated that it wants to achieve significant savings in transfer payments to provincial governments, most of which are part of its "social affairs" budgetary envelope. The federal government has also instituted major changes in the Equalization Program since 1977 in an effort to limit its outlays. Provincial dissatisfaction with some aspects of the fiscal arrangements is also indicated by the withdrawal of Alberta - and the threatened withdrawal of British Columbia - from the Tax Collection Agreements.

The Council is of the opinion that basic changes in the Fiscal Arrangements Act cannot, and should not, be postponed indefinitely. We have had as our objective the search for long-term principles to govern these arrangements that are equitable to all parties concerned, that contribute to

stability, and that are durable in the face of rapid economic change. In some instances, the Council feels that these principles can be implemented in the forthcoming legislation. In other cases, the Council recognizes that further information and analysis is required before its proposals can be fully assessed. Adoption of these proposals would also require a wide degree of public and governmental support, which can only be achieved by extensive and thorough public examination and discussion. The Council urges that the federal and provincial governments accord high priority to examination of these longer-run proposals.

The Council's analysis has focused on six aspects of federal-provincial fiscal relations. We have examined the question of whether there is evidence of "fiscal imbalance" between the two levels of government that requires reductions in federal transfers to the provinces. We have also examined questions concerning the future of the Equalization Program, Established Programs Financing, and of federal-provincial transfers in the areas of health and postsecondary education. Another subset of questions concerns the future of arrangements dealing with fiscal co-ordination between the federal and provincial governments in such areas as taxation and stabilization policies. Finally, the Council has examined questions relating to openness and accountability in the process of negotiating the fiscal arrangements. Our recommendations concerning each of these areas follow in succeeding sections of this chapter.

FISCAL IMBALANCE AND PROPOSALS FOR REDUCTIONS IN FEDERAL-PROVINCIAL TRANSFERS

For the first time in the history of the fiscal arrangements legislation, as indicated in Chapter 1, the federal government is approaching negotiations with the provinces with the intention of reducing the amount of transfers. Specifically, the federal Minister of Finance indicated in his Budget of October 1980 that his goal was to achieve savings in federal transfers to the provinces of around $1.5 billion in 1982/83 and 1983/84. Subsequent statements by federal government spokesmen have indicated that much of that reduction is expected to come from transfers to the provinces for social programs.

Two reasons have been advanced for the federal proposal to reduce federal-provincial transfers for social affairs. In the first place, the Minister of Finance has stated that "the most urgent priority of the federal government is to strengthen its fiscal position," adding that "transfers to the provinces cannot be insulated from policies of restraint." In support of this position, the Minister has also argued that there exists an

"intergovernmental fiscal imbalance" in Canada at present, which he defined as "the fact that one order of government has a large and persistent deficit or surplus in its accounts in relation to that of another order of government."[2]

This reasoning, if accepted, would support general cuts in federal-provincial transfers. It does not support reductions in transfers for social programs in particular. The October 1980 Budget indicated, however, that the federal government wished to reallocate its spending from social affairs to economic development.

The Council has considered these rationales for reductions in federal-provincial transfers in general and for transfers for social programs in particular. The argument that there is a fiscal imbalance in the Canadian federal system might have merit if, for instance, it could be shown that there was a structural obstacle in our federation that barred access by federal or provincial governments to the revenues needed to fulfill their constitutional responsibilities. Since both federal and provincial governments in fact have access to all major revenue sources, the Council sees no evidence that such a structural imbalance exists in our federal system. The mere existence of deficits at one level of government does not indicate the existence of such a structural imbalance nor does it mean that such deficits have to be rectified at the expense of another level of government.

This is not to say that the federal deficit has been of no concern to the Council. We have found no meaningful evidence, however, that would link increases in the federal deficit between 1975 and 1980 to federal-provincial transfers. Perhaps most importantly, the Council finds that with the acquisition of new revenue sources as a result of the recent federal-provincial agreements on energy pricing, the budgetary outlook of the federal government has substantially improved.

The Council also notes that the effects of reductions in federal transfers to provincial governments have to be considered for <u>both</u> levels of government. The fact is that of ten provincial governments, all but the three resource-rich western provinces have been incurring budgetary deficits in recent years, despite several years of general restraint in the growth of provincial expenditures. As noted in Chapter 1, federal-provincial transfers constitute a large proportion of the revenues of many of these provincial governments. Strictly from a budgetary point of view, therefore, the Council sees little merit in reductions in federal-provincial transfers that

would, in effect, merely shift part of the burden of a declining federal deficit to less fortunate provincial governments.

As noted above, the proposed reduction in transfers to provincial governments for social programs also indicates a change in the priorities of the federal government. This proposal may reflect a conviction on the part of the federal government that it has been paying more than its "fair share" of expenditures in the areas of health and higher education - a conviction that may have been reinforced by the outcome of the 1977 negotiations relating to the Revenue Guarantee. As a result of these negotiations, the federal government transferred to the provinces through the EPF program the equivalent of two personal income tax points in order to reach compromise on the termination of the Revenue Guarantee Program then in place, a concession that some observers viewed as giving the provinces an undeserved bonus.

One of the major problems that has arisen with respect to the transfer of funds to the provinces by the federal government under the EPF programs concerns the lack of accountability as to the efficiency and effectiveness of these expenditures. Because an improved system of accountability could better assure the achievement of federal objectives, we intend to focus some attention on means of resolving this problem.

The Council is clearly not in a position to express judgment about the overall priorities of the federal government, as reflected in the 1980 Budget. At the same time, however, we do not consider that a reduction in EPF transfers is consistent with either the resolution of the financing problems currently existing in the fields of health and postsecondary education or the attainment of the federal government's stated objectives with respect to these sectors.

Accordingly,

1 **We recommend that the federal government reconsider the proposed reduction in transfers to the provinces.**

THE EQUALIZATION PROGRAM

The program of federal equalization payments to "have-not" provinces is one of the major vehicles of intergovernmental redistribution in Canada. Its importance to the nation is shown by the agreement among all governments to give it formal status in a patriated Constitution. A significant part of the Council's work has involved an examination of the past and future of the program, which is due to expire in 1982.

The program has run into significant difficulties in recent years. A previously stated objective of this program - to raise the revenue capacities of all provincial governments to the average for all Canadian provinces - has not proved to be sustainable. This has been a consequence of the increase in natural resource revenues that has accrued to western provincial governments since 1973. These increases in revenues did not accrue to the same extent to the federal government, which was nevertheless forced as a consequence to make large disbursements in equalization payments to the "have-not" provinces out of its general revenues. The resulting pressure on its budget led the federal government to impose a number of ad hoc limitations on the extent to which resource revenues enter the equalization formula and the extent to which provinces are eligible to receive payments.

These restrictions have had some unfortunate effects in terms of equity. The most notable of these effects has been on Ontario. Federal taxpayers in this province contribute substantially to the financing of the Equalization Program. But Ontario was made ineligible to receive equalization payments by a change in the rules of the program that disqualified provinces in which personal per capita income was above the national average in the current and two preceding years. The result is that the net effect of the Equalization Program is to reduce Ontario's revenue capacity to well below that of the national average.

At first glance, it appears as though the resource-rich provinces escape lightly in contributing to the financing of the Equalization Program. This, however, is only part of the picture. Council research indicates that the amount of redistribution that takes place as a result of inclusion of natural resources in the Equalization Program is dwarfed by the amount of redistribution that has been taking place through other mechanisms. For example, an estimated $13 billion of natural resource rents were redistributed from Alberta to the rest of Canada in 1980 mainly as a result of the federal government's policy of maintaining the domestic price of oil and gas well below world levels. This implicit transfer exceeded all cash transfers from the federal to provincial governments in 1980/81. It is obvious, therefore, that the treatment of natural resource revenues in equalization cannot be considered in isolation from the more general issues of the sharing of resource revenues and jurisdictional rights to these resources.

The Search for Principles Governing Equalization

The treatment of natural resource revenues may be one of the most difficult issues that must be faced with respect to

equalization in future; it is the view of the Council, however, that it may not be the most fundamental issue. A more pressing concern may be the determination of principles on which a sound and durable equalization program can be based.

The ad hoc changes made during the lifetime of the present program have called into question the principles on which the program was originally based. Moreover, substantial opposition to the concept of equalization has also developed among some economists in recent years. It can be argued that the present system of intergovernmental transfers (including equalization) and governmental transfers to persons conflicts with the goal of national economic efficiency. It has been contended that this transfer system has led to an unhealthy dominance of government expenditures in the economies of the "have-not" provinces, with some of the latter being reduced, in effect, to a state of dependency. It is also maintained that the transfer system has undermined automatic adjustment mechanisms, such as migration, that would otherwise ameliorate problems of high unemployment and low income in the "have-not" provinces.

The opinions outlined above have become the "conventional wisdom" in some policy-making circles in Canada. They assume even greater importance in view of the present public focus on the problem of slow economic growth and the related need for reallocation of resources in the economy.

For the above reasons, the Council's consideration of the future of the Equalization Program began with a re-examination of the rationale that led to its creation. Through our analysis, it was demonstrated that there is an important role to be played by a program of equalization grants in Confederation. The results of this analysis can be briefly outlined.

Although equalization redistributes revenues between governments, our primary concern is the welfare of people rather than governments. The criteria governing an equalization program should be aimed at achieving the people-oriented goals of equity and efficiency, the latter being necessary to increase the standard of living of Canadians generally. The issue of equity arises in relation to the common objectives of governments in Canada to reduce inequalities in real income between individual persons (vertical equity) and to provide similar treatment to people in similar economic circumstances (horizontal equity).

Given these as the generally accepted goals of government policy, the following fundamental question was asked. Why do we need an intergovernmental transfer system when we have in place,

at both levels of government, a well-established system of taxes and transfers among persons, households, and firms for regulating the allocation of economic activity and the distribution of its fruits? In other words, what can (or ought to) be accomplished through a system of intergovernmental transfers that could not be accomplished through the tax and transfer system?

The basis of the case for an equalization program lies in the fact that in a federal system such as Canada's, the "market" or taxable incomes of persons do not provide a completely accurate reflection of the real incomes of persons living in different provinces. Provincial government activities give rise to real income differences in the form of net fiscal benefits (defined as the share of public services that a person receives minus the taxes he or she pays) that are not reflected in the personal incomes of individual people. Differences in net fiscal benefits may arise because provinces with high per capita incomes can finance a given amount of public services with less tax effort (lower tax rates on income) than provinces with lower per capita incomes. These differences may also arise because a resource-rich province can use the revenues collected from its natural resources (such as oil rents) to finance public services and at the same time maintain relatively low levels of taxation. The distribution by provincial governments or their agencies of resource revenues in the form of implicit subsidies to users of provincial services (for example, through artificially low electricity prices) constitutes another source of differences in net fiscal benefits that are not reflected in personal incomes.

Since the goals of equity outlined earlier require that governments concern themselves with the <u>comprehensive</u> incomes of individual persons, and since the current tax and transfer system is based primarily on personal market incomes, an additional redistributive transfer system that deals with differences in net fiscal benefits from provincial government activities is required to attain equity goals. This purpose can, and should, be served by an equalization program.

There is one important modification to the argument that an equalization program should eliminate <u>all</u> differences in provincial net fiscal benefits in order to achieve equity goals. Recognition of the provincial ownership of natural resources granted to the provinces under the BNA Act can be interpreted as conferring certain property rights on the residents of any province over that province's natural resources. The implication of this constitutional provision is that provincial natural resource revenues that are actually distributed to provincial residents should, for reasons of equity, be treated

differently in an equalization program. Only a portion of these benefits should be equalized, with the proportion being determined by the tax rate that would apply to these benefits if they were distributed to citizens by provincial governments in the form of personal income and then subsequently made liable to taxation by the federal government.

As noted above, the impact of the Equalization Program on efficiency in the allocation of resources has been a matter of controversy. Our analysis of the argument that equalization has resulted in an inefficient allocation of resources in the economy led to the exact opposite conclusion. It was found that an equalization program is essential to the efficient functioning of the economy. Economic efficiency requires that factors of production be guided among activities (including those in different provinces when this is an option) by signals related to their productivity in different locations. Differences in net fiscal benefits among provinces tend to distort the market signals that would otherwise be expected to do this job. The only solution to this problem is to eliminate the source of such distortions - that is, the differences in net fiscal benefits arising from provincial government activities.

The empirical research demonstrated that the past effects of equalization and of differences in provincial government financial capacity (arising from natural resource revenues in particular) on the interprovincial migration of labour have been significant enough to justify consideration of the potential efficiency costs of adopting alternative approaches to equalization in the future. It was shown that for low-income persons in particular, these aspects of fiscal structure have been of roughly the same importance as regional differences in employment and income in explaining the recent trends in interprovincial migration. It is evident, therefore, that future increases in the domestic price of oil towards world levels and the resulting increase in the revenue capacity of producing provinces and in the fiscal benefits available to their citizens, particularly if natural resource revenues remain only partially equalized, could have a corresponding impact on the movement of labour. This, in turn, could create further problems with respect to the achievement of economic efficiency.

The Guiding Principles in Summary

The critical questions with respect to the future of the Equalization Program concern how much in the way of financial resources should be distributed and how. Our analysis provides some answers to these questions after beginning with the

assumption that one starts from scratch to develop a fair and effective system of equalization unimpeded by constitutional, political, or other constraints.

Such an equalization program would have as its objective the complete elimination of all differences in the net fiscal benefits received by citizens in different provinces. Put another way, the per capita financial capacity of all provincial governments would be completely equalized. This is the only solution that would be compatible with attainment of equity in the treatment of citizens and efficiency in the allocation of resources in a federal state. There would be no necessity for a federal government to be involved at all in such an equalization program; the redistribution involved would be most simply achieved by direct redistribution between provincial governments.

In actual fact, of course, equalization has long been embedded in Canada's federal-provincial system and has evolved over the years in response to constitutional and political imperatives that cannot be ignored when considering possible program reform.

In the first place, recognition of the ownership of natural resources, granted to the provinces in the Constitution, can, as previously noted, be interpreted as conferring property rights with respect to natural resources on residents of any province. This constitutional provision suggests that there are limits on the extent to which natural resource revenues should be redistributed through equalization. For this reason, the Council has suggested that the amount of resource revenues to be redistributed should be equivalent to the amount that would be paid to the federal Treasury through income tax if natural resource revenues were distributed to residents of a province as income.

The recent constitutional discussions and proposals also have implications for the mechanics of the Equalization Program. As indicated, it was universally agreed by all governments participating in these discussions that the equalization concept should be enshrined in a patriated Constitution. Also, there still appears to be widespread agreement that the responsibility for implementing equalization should continue to be assigned to the federal government.

The Financing of the Equalization Program

The guiding principles outlined above present problems for the financing of the Equalization Program. While the distribution

of provincial financial capacity for revenue categories other than natural resources generally matches the distribution of federal revenue sources, this has not been the case for natural resource revenues. In fact, until the recent agreement was reached on petroleum pricing and revenue allocation, it was difficult to reconcile constitutional assignment of property rights over natural resources to provinces and federal responsibility for a program that equalizes access to these resource revenues. The Council is of the view, however, that this problem, which has plagued the financing of the Equalization Program for some years, has been greatly reduced with the conclusion of the energy pricing agreements between the federal government and the oil- and gas-producing provinces.

This is not to say that all questions related to the financing of equalization payments arising from natural resource revenues or rents have been settled for all time. The problem of financing equalization payments is accentuated when there are sharp increases in the value of a resource that is unevenly distributed across the country. The large increases that have taken place in energy prices since 1973 have highlighted this problem. While oil and gas rents are currently of a size that dwarfs all other rents collected or distributed by governments, it is entirely possible that the role of oil and gas rents in our recent history will be replaced in future by rents arising from other resources.

The Determination of Equalization Payments

Provincial Non-Resource Revenues

The Council sees no major problems with the mechanics of the present Equalization Program insofar as its treatment of revenues other than natural resource revenues is concerned. Although a number of changes to the "ideal" program are involved, the Council does not believe that they are of overwhelming significance.

The only modification to this part of the program that the Council would propose concerns the role of local government revenues from property taxes. Part of these revenues (those related to school taxes) are already included in the equalization formula. The Council considers that there are good reasons for including all local government revenues from property taxes. As noted above, we view the objective of the Equalization Program as being to reduce the interprovincial differences in net fiscal benefits between persons that arise from regional government activities; it makes no difference

whether these net fiscal benefits arise because of provincial government activities or local government activities.

Therefore,

2 **We recommend that all local government property taxes be included in the equalization formula.**

Resource Revenues

A considerable amount of Council analysis has been devoted to the problem of developing equitable, uniform, and durable principles to govern that part of the equalization formula relating to resource revenues. It should be reiterated that this is the aspect of the present equalization formula that is most arbitrary. At present, equalization of resource revenues is limited to one-third of the total equalization payments. Within the resource revenue category, moreover, different types of revenues receive totally different types of treatment: some revenues are equalized in full (e.g. renewable natural resource revenues, such as forestry revenues); only half of other revenues are equalized (revenues arising from non-renewable resources); and some resource revenues that are collected by provincial governments are no longer equalized at all (revenues from the sale of Crown leases).

In addition to the provincial natural resource revenues that are taken into account for equalization purposes, as outlined above, the provinces also have available to them large economic rents from certain natural resources that are not collected but, instead, are passed on to consumers in the form of subsidized prices. These forgone revenues, however, are not included at all in the equalization formula. The Council considers there to be a need to determine the magnitude of rents being passed on to consumers in this way. While the case of hydro-electricity is the most obvious example, it is undoubtedly not the only one.

Based on our analysis, we have concluded that in the longer term the following principles should apply with respect to inclusion of resource revenues in the equalization formula:

- all natural resource revenues distributed by provincial governments to residents of a province should be taken into account in the equalization formula. It is immaterial whether this distribution takes place directly in the form of goods and services and/or tax relief, or indirectly in the form of subsidized prices;

- resource revenues should be equalized when they are distributed as income to residents of the provinces. Thus funds deposited in heritage, or other savings, funds should not be equalized; they should only be subject to equalization when they commence to provide benefits to provincial residents;

- the amount of provincial natural resource revenues that is subject to equalization should approximate the federal taxes that would be paid, on average, if resource revenues were distributed to provincial residents and treated as personal income;

- there should be no artificial limits, as at present, on the extent to which eligible natural resource revenues are equalized.

It is of considerable importance to outline the likely financial effects of applying these principles to the treatment of natural resource revenues in the equalization formula. These effects may best be assessed in relation to those of our other proposals with respect to the Equalization Program. The latter would have the result of increasing total outlays on equalization and would not significantly decrease the equalization payments currently going to any individual provincial government. By way of contrast, incorporation of the principles with respect to the treatment of natural resource revenues would not only lower the total outlays on equalization in real terms over the long run but would also redistribute the payments significantly.

Preliminary econometric simulations of the proposed changes indicate that if they were implemented immediately the amount of equalization payments resulting from natural resource revenues would be substantially reduced. But if these changes were introduced some years down the road, when domestic oil and gas prices and thus the revenues of producing provinces will be considerably higher, the amount of equalization payments resulting from resource revenues would be only moderately lower than they would be under the present formula.

The proposed treatment of natural resource rents whereby they would be distributed in the form of price subsidies to consumers would also significantly alter the distribution of equalization payments among provinces. This reflects the fact that natural resource benefits are more evenly distributed across the nation than appears to be the case when account is taken not only of resource revenues collected by the provinces through taxation but also of uncollected economic rents passed on to consumers through subsidized prices.

In submitting these proposals, the Council is under no illusions as to their immediate acceptability or applicability. Indeed, it would be presumptuous to assume otherwise, especially since the reduction of equalization payments that would result from a system based on these principles might seriously affect the fiscal capacity of the poorest provinces. Our primary goal is to provoke further public examination and discussion.

We also believe that fundamental changes in the treatment of resource revenues under the Equalization Program should not be put off indefinitely. Further ad hoc changes will undoubtedly take place in the absence of any decision on the fundamental principles that should guide this part of the program; the present inequities in this part of the program will continue. The Council is concerned, however, that any interim arrangements with respect to the treatment of natural resource revenues in the equalization formula should not impede movement towards a program based on more enduring principles.

Until such a program emerges, the Council believes that it would not be appropriate, or desirable, for equalization payments to increase substantially from their current levels, in real terms, on account of natural resource revenues. Some form of constraint should therefore be placed on the payments arising from the equalization of these revenues in the interim. At the same time, however, the Council does not think that it would be desirable, or appropriate, for equalization payments arising from natural resource revenues to be reduced significantly in real terms pending the adoption of longer-term arrangements.

Accordingly,

3 **We recommend that, until more permanent arrangements can be established, total equalization entitlements arising from natural resource revenues for all the provinces having positive resource revenue entitlements should be constrained. The constraint applied to annual growth, beyond the level for 1981/82, should be determined either by the yearly rate of growth in equalization payments arising from non-resource revenues or by the annual rate of growth in national economic activity, as measured by an indicator such as gross national product.**

Given the above constraint on the growth of positive equalization entitlements arising from natural resource revenues, the Council considers it important that the distribution of entitlements to equalization be determined as equitably as possible under present circumstances. More particularly, it believes that there is little justification for

calculating entitlements for renewable and non-renewable resources on a different basis and for excluding revenues from the sale of Crown leases in the calculation of entitlements.

Therefore,

4 **We recommend that, in determining entitlements before applying the constraint previously proposed, all revenues from non-renewable resources and from the sale of Crown leases be included for equalization purposes.**

The Council has one final recommendation with respect to the Equalization Program that it considers should be implemented immediately. The provisions of the Equalization Program should not treat Ontario or any other province in an arbitrary and anomalous fashion.

Therefore,

5 **We recommend that any special provisions that could have the effect of barring a province from receiving equalization payments be excluded from the Fiscal Arrangements Act. The equalization formula should apply uniformly to all provinces without exception.**

ESTABLISHED PROGRAMS FINANCING

Constitutionally, health care and education primarily fall under the jurisdiction of the provinces. Over the years, however, the federal government has become more and more involved, in response to public pressure for the development of countrywide health and education services that conform to accepted standards. The Royal Commission on Health Services observed in the early 1960s that health had become a matter of national concern that no enlightened government could ignore. At the time the Commission's report was published, the Hospital Insurance and Diagnostic Services Act was in force; the Medical Care Act followed a few years later.

The federal government has also been heavily involved in postsecondary education since the early 1950s. Without substantial federal support in one form or another, most provinces would have found it difficult to provide the desired level and quality of education for their rapidly expanding populations of young people. In addition, the federal government has contributed directly to scientific research and to studies in the humanities in the postsecondary educational institutions, to manpower training, and to the support of students in both undergraduate and graduate programs. Better

education, improved skills, and more-intensive research contribute to Canada's economic growth, enable the Canadian economy to be more competitive in international markets, and improve the mobility and productivity of the Canadian labour force. In these ways, federal funding of postsecondary education helps to achieve national goals.

Up to 1977, federal-provincial agreements were based on shared-cost programs involving hospital and medical insurance plans. Under these programs, the federal government paid approximately half the costs, on the condition that the provinces would meet national standards with regard to accessibility, universality, and comprehensiveness of available services. Similarly, the federal government paid one-half or more of the provincial operating costs of postsecondary education institutions in each province, with no conditions or standards attached. In 1977, the Established Programs Financing legislation provided for block funding of health care and postsecondary education, which gave the provinces more flexibility in the allocation of funds within and between programs.

Current Issues and Options

Since the adoption of the landmark changes brought about by Established Programs Financing, the provinces have encountered no serious problems with these financial arrangements. Certainly, there have been no widespread demands on the part of the provinces to have the EPF program significantly revamped or abandoned. The federal government has expressed concern, however, over the increase in its transfers as a share of the EPF program costs and over the compatibility of block funding with the maintenance of national standards. In its presentation to the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, the federal government advocated that the EPF arrangements be revised to provide an effective mechanism for requiring that provinces accept the national health care standards embodied in either the existing or new federal legislation.

Funding for the EPF programs comes from cash payments and tax-point transfers from the federal government to the provinces. As it stands now, the federal contributions will increase at roughly the same rate as the gross national product until, for each province, the value of tax-point transfers equals the value of cash payments.

Should the federal government decide that economic conditions no longer permit such growth or that its level of funding is too

generous, it could negotiate a cut in EPF transfers. That would leave the provinces with essentially two alternatives: 1/ they could increase taxes in order to make up the loss of federal revenue, institute higher user fees, and/or incur larger deficits; or 2/ they could reassess their priorities - in health care, education, and elsewhere - and reduce their services accordingly. In either case, the brunt of the adjustment would fall on the provincial taxpayer or recipient of services. In turn, the federal government could apply the funds saved to reduce its deficit, to cut federal taxes, or to finance some other federal expenditures. A cut in federal government transfers would only shift the burden of costs from one level of government to another, with no guarantee of any real gain in national terms.

If federal-provincial transfers were not cut but were maintained at the levels provided at present under Established Programs Financing, three basic options would emerge: 1/ disentanglement of the funding by the two levels of government; 2/ a more gradual evolution from the status quo; or 3/ an extension of earlier cost-sharing arrangements. Each of these options is described below.

1 A substantial disentanglement of federal-provincial transfers would mean a partial, or possibly complete, replacement of EPF cash payments by unconditional transfers of tax points, along with associated adjustments in the Equalization Program. This option would be more in accord with the jurisdictional division between the two levels of government than any other option; and with a clearer separation of responsibilities, the potential for federal-provincial friction would probably diminish.

2 Evolution of the status quo implies that the federal government would continue to raise much of the revenue related to EPF programs and would continue to pay blocks of funds to provincial governments with few strings attached; however, it would have some power of suasion. On the provincial side, it implies that the provinces would continue to deliver the services, would have substantial control over the various programs, and would agree to certain national standards, or levels, of service.

The main advantage of this option is that it would not alter a system that now grants the provinces the flexibility they have demanded and one that leaves the door open for a stronger federal role should conditions make it necessary.

3 Cost sharing at present is not part of the EPF arrangements. This option could mean a return to the cost-sharing programs in existence prior to 1977. Also new types of cost-sharing schemes could be introduced. This might include new initiatives, in areas such as pharmacare and dental care, or possibly in the reallocation of some EPF payments to federal scholarships and research grants. While these new services would be delivered by the provinces, the costs of the programs would be more closely shared and the objectives more closely determined between the two levels of government.

The choice between these three options is difficult because the underlying issues are complex. They are intertwined with the history of Canadian federalism, with the question of federal-provincial jurisdiction, with the inability of the lower-income provinces to finance the necessary services from their own resources, with the reluctance of the higher-income provinces to carry more of the burden of provincial equalization, and with the unfavourable economic climate that is constraining the revenue capacity and expenditures of the federal government. The choice of options will likely differ between the federal and provincial governments because their political goals and economic priorities are not necessarily the same.

From the analysis in Chapters 6 and 7, the Council concludes that the provinces, for the most part, have not taken undue advantage of the increased flexibility of Established Programs Financing to reduce their spending on health, higher education, and related programs. Some spending restraints have occurred, but generally they appear to be in line with EPF objectives. The analysis also shows that some major changes have taken place in the type and range of health services, but these changes, too, could be expected under the more flexible arrangements of EPF funding.

At present, there is no legal requirement under the EPF arrangements to separate the funds for postsecondary education from those for health care, nor has there been any undertaking by the provinces to earmark funds from the federal government for either purpose (or for EPF programs, for that matter). The federal government follows the convention of dividing up the EPF financing among the programs and of even issuing the cash portion in three separate cheques to each province. In comparing the federal government's designation of funds with the expenditures on the various programs by the provinces, some observers have arrived at conclusions about the trends in the sharing of program financing between the federal government and the provinces. It has been claimed, for example, that the

federal government pays more than half of the operating costs of postsecondary educational activities and that this share has increased since 1977.

Because of the complexities and the differing viewpoints, there is no way to settle definitively the arguments about trends or fairness in the fiscal arrangements as they now apply to postsecondary education. The conditions and undertakings are even more hazy than they are for health care. In a broad qualitative sense, there is widespread agreement that some remarkably good developments in postsecondary education have taken place in Canada over the past quarter century and that both the federal and provincial governments deserve credit for these accomplishments. It is also agreed that in virtually all provinces (more so in some than in others) the generosity of postsecondary education funding by provincial governments has declined in recent years. But to attribute this to provinces having taken advantage of the flexibility in the EPF arrangements to squeeze their universities and colleges is to ignore the other important factors influencing educational developments.

Despite these complexities, the Council believes that federal-provincial transfers for health care and postsecondary education should be maintained at this time. Furthermore, we believe that the provincial expenditures under Established Programs Financing should be monitored more closely in order to lay the basis for a system of greater accountability with respect to the magnitude and the employment of funds transferred to the provinces. Over the longer run, such an approach would help to settle the issue of how the federal government might reasonably exert tighter controls on service costs in order to ensure "national standards."

Health Care

Hospital care, medical care, and extended health care account for a large part of federal-provincial transfer payments. Concerns have been expressed that health care will become less accessible to Canadians as costs escalate and as governments tighten their belts; that the transfers from the federal government will not be sufficient to meet provincial expenditures; and that today's level of health care would not, or could not, be maintained if the federal government were to relinquish its role of financial assistance. In view of these concerns, it is important that the public be better informed about the performance of the Canadian health care system. In particular, the public needs to be informed about such items as the amount of federal transfers to the provinces; the provincial

variations in per capita expenditure levels; the sources of provincial disparities in levels of service; the changes in costs per capita over the years; the sources of cost increases; and the state of health of Canadians, as measured by a variety of health indicators.

In the review of hospital expenditures, wide variations were observed in per capita operating expenditures among the provinces. These variations were attributed to provincial differences in patient-days per capita and costs per patient-day. They, in turn, were traced to provincial differences in the age distribution of the population, in hospital admission rates, length of hospital stay, labour hours per patient-day, and wage rates per hour. Furthermore, it was shown that these provincial variations have widened in recent years. On the basis of currently available data, this kind of analysis could be extended to show by how much the levels of service differ in different institutions, why they differ so much, and to what extent the provincial levels of service change over the years.

Our analysis also underlines the provincial variations associated with physicians' services. For example, the volume of physicians' services, measured on a per capita basis, is substantially lower in some of the Atlantic provinces than in other provinces. This is not because the productivity of physicians is lower in those provinces - it was actually found to be higher - but primarily because the number of physicians per capita is lower. Moreover, there are significant provincial variations in the extra billing of patients by physicians and in the extent to which they have opted out of the system. The latter variations are at present not nearly as great as those in provincial per capita services, but because such practices could lead to a serious erosion of the accessibility of the public health care system in the longer run, we believe they should be regularly monitored through the review of publicly available information.

Established Programs Financing enables the provinces to allocate funds from the federal government more nearly in accord with provincial priorities. With a rising gross national product, the per capita funding of provincial health expenditures is being gradually increased. These increases are designed to accommodate wage and price inflation and, at the same time, allow for some real improvements in the quantity and quality of service over the longer term. Established Programs Financing also provides the provinces with additional funding for extended health care. These funds are being allocated by the provinces to a variety of services. As indicated by the

analysis, provincial variations in expenditures on these services are even greater than those on hospital or physicians' services. With a rising gross national product, federal funding for extended health care services is likely to be increased in the same manner as funding for the other health services.

While it is not possible at present to quantify all aspects of health services, enough data are being collected on hospitals and mental institutions to account more clearly for the provincial variations and the sources of change in provincial expenditures and services as they occur over the years. Statistics Canada has collected data on hospital expenditures and services, as well as on mental institutions, for many years. Data on extended health care services, however, have only been collected since 1976 and are not published annually. Data on physicians' services are not being collected by Statistics Canada but by the Department of Health and Welfare Canada. Data in these different areas of service are not all of the same quality or equally accessible. If health care standards and levels of service were to be monitored more closely, the quality of, and access to, provincial data would need to be improved in certain areas, particularly in that of extended health care.

As a first step in the process of providing for greater accountability, we propose that the transfers by the federal government to the provinces under EPF for health care and postsecondary education be allocated separately so that the manner in which those funds are employed can be more readily determined than at present. As a means of more closely monitoring developments over a wide area of concern with respect to health care expenditures and services, the Council concludes that it is essential for the federal government, in co-operation with the provinces, to establish a system under which all relevant and up-to-date statistics would be made available on an annual basis. This would include statistics on the operations of all hospitals and mental institutions, physicians' services, and extended health care facilities.

As a final step in the accountability process, we urge that the federal Minister of Health and Welfare Canada submit an annual report to Parliament on the operation of all facets of the health care system so as to provide a basis for consideration of the issues surrounding them by both the public and Members of Parliament.

For all of the above reasons,

6 We recommend the establishment of an improved and more comprehensive system of monitoring developments in all relevant areas of the Canadian health system in order to provide the basis for greater information to the public and to Parliament with respect to the efficiency and cost-effectiveness of federal transfer payments to the provinces. In particular, we propose:

a/ that transfers by the federal government for health care and postsecondary education be designated separately; that the allocation of such funds be carefully tracked; and that a system of publishing provincial accounts and statistics for expenditures on health care be established;

b/ that timely and pertinent data be provided on health care expenditures and services covering hospitals, mental institutions, physicians' services, and extended health care facilities annually and, as far as possible, in integrated form so that they can be analysed and interpreted by the federal and provincial governments on a comparable basis;

c/ that extended health care facilities be monitored more closely by federal and provincial governments to ensure that some of the more basic services covered by this provision are available in all provinces on a similar basis;

d/ that provincial disparities and future changes in the service levels of physicians, together with the extent of opting out and of extra billing by physicians, be monitored on a continuing and non-confidential basis; and

e/ that the federal Minister of Health and Welfare Canada table in Parliament an annual report on the performance of the Canadian health care system so that all information pertaining to federal-provincial funding, levels of service, accessibility, provincial disparities, and quality of service will go on public record and the issues surrounding them will be open for public and parliamentary debate.

It is probably fair to say that at the time of the enactment of Established Programs Financing in 1977, the health services of all ten provinces conformed to the basic conditions of accessibility. To attain greater flexibility in the provincial allocation of funds for health care, the federal government and the provinces agreed on cash and tax transfers. Complete

reliance on tax transfers was unacceptable to the federal government because elimination of conditional cash transfers could have eroded the basis for preserving the existing standards of service. For example, user charges in a province could have been raised to excessively high levels. Without "conditional" cash transfers from the federal government to the province, it would have been difficult, if not impossible, for the federal government to have arrested the growth of such user charges. There is no reason to believe that this is not as true today as it was in 1977.

Therefore,

7 **We recommend that the federal government continue to provide cash transfers for part of the funding of provincial health insurance so that reasonable standards of accessibility will be assured in future.**

As demonstrated in our analysis, part of the provincial variations in the cost of hospital services stem from provincial differences in the age distribution of the population. According to our estimates, such differences account in some cases for more than 20 percentage points of the provincial variations in length of hospital stay, and they suggest that hospital costs in some of the provinces are substantially higher than in others because of the age factor.

Consequently,

8 **We recommend that, to the extent that provincial variations in age composition give rise to provincial differences in hospital costs, the distribution of the cash transfers from the federal government to individual provinces be adjusted to take account of such age differences. This should be done without increasing the total costs of the program.**

Education

Postsecondary education is perhaps one of the most contentious areas of federal-provincial relations. Education is primarily under the constitutional jurisdiction of the provinces, and in all provinces - particularly Quebec - it is considered a key element of cultural aspirations. At the same time, it must be recognized that provincial decisions on postsecondary education can have national implications, especially with regard to the mobility of people between provinces.

As it stands now, the federal government's role in post-secondary education is not clearly defined. Some of the federal commitments to funding postsecondary education programs are targeted to meet specific objectives in such areas as student aid and research grants, which provide effective levers for the implementation of federal policy. Other federal commitments, however, are not directly linked to such objectives. We are concerned about the lack of an established and clear federal role, however broad or limited it may be.

Therefore,

9 **We recommend that the federal government define and clarify its interests in, and potential influence on, postsecondary education before the next negotiations of the Fiscal Arrangements Act towards the end of the decade.**

Prior to 1977, part of the federal cash transfer to the provinces was for the purpose of funding postsecondary operating expenditures. Now it is an unconditional transfer and not linked to the actual level of provincial expenditures. We believe, given the sensitivities of the provinces, that the unconditional nature of federal cash payments is appropriate.

Accordingly,

10 **We recommend that the federal government, through its EPF transfer to the provinces, continue to provide strong support to postsecondary education. As long as provincial governments do not discriminate against students from other provinces or discourage student mobility in general, the federal contribution should remain unconditional.**

Provincial policies relating to postsecondary education have implications that reach beyond provincial boundaries. Some degree of interprovincial co-ordination is currently achieved through various academic associations involving postsecondary institutions and through the Council of Ministers of Education, Canada, which is composed of the ten provincial Ministers. The federal government is not a party to this process of co-ordination, even though it makes substantial financial contributions to postsecondary education.

To remedy this shortcoming,

11 **We recommend that the federal and provincial governments establish a formal and continuing dialogue for the purpose of improving federal-provincial co-operation on matters relating to postsecondary education policies.**

Finally, the Council feels that issues of national concern in the area of postsecondary education should be debated in the Parliament of Canada. The Secretary of State should inform Members annually about the status of federal programs affecting postsecondary education.

Therefore,

12 **We recommend that the Secretary of State table in Parliament an annual report on the effectiveness of federal programs relating to postsecondary education.**

THE TAX COLLECTION AGREEMENTS AND THE OBJECTIVES OF TAX AND FISCAL HARMONIZATION

An important objective in any federal state is that of fiscal harmonization. The aim is to establish fiscal arrangements that permit provincial governments to institute expenditure and income distribution policies according to their own individual priorities - policies that, at the same time, cause the least fiscally induced distortion in the distribution of the economy's resources.

Harmonization of taxation arrangements between the federal and provincial governments is an important method of attaining fiscal harmonization. Tax harmonization is primarily, but not exclusively, achieved in Canada by the Tax Collection Agreements between the federal and provincial governments. Under these agreements, the federal government collects personal and corporate taxes for participating provinces that agree to certain conditions - primarily to adopt the federal definition of what constitutes taxable personal income or corporate taxable income. All provinces except Quebec participate in the agreements with respect to personal income tax; all provinces except Quebec, Ontario, and Alberta participate in the agreements with respect to the collection of corporate income tax.

Our view of developments in the taxation arrangements between the federal and provincial governments over the last 40 years is that they have, by and large, been healthy. Since 1941, Canada has shifted from a system of complete centralization of personal and corporate income taxes to a much more flexible sharing of income taxes between federal and provincial governments. The increased flexibility that has been attained by the provinces in determination of their income taxes has not prevented them from maintaining uniformity in important areas of taxation practice - whether or not they are members of the Tax Collection Agreements. Thus all provinces agree to rules governing the

allocation of individual incomes and corporate profits for purposes of provincial taxation, and these rules prevent double taxation of income and other problems that arose in the "tax jungle" of the 1930s.

At the same time, however, there have been some developments in the area of taxation that have been a cause for concern. The Council would like to address remarks and recommendations to two such issues: discriminatory taxation measures; and tax competition among provincial governments.

Discriminatory Taxation Measures

On several occasions in past years, provincial governments have attempted to institute taxation measures that would discriminate in favour of provincial residents who receive dividends from companies having headquarters in the province concerned. The federal government has refused to administer discriminatory tax proposals advanced by provinces that are parties to the Tax Collection Agreements. This prohibition, of course, does not apply to the provinces that are not parties to the agreements.

The economic case against these discriminatory measures is a classic one. They create barriers to the mobility of capital and goods within the nation. Such restrictions impede the allocation of resources to their most productive uses. From a practical point of view, the benefit of such discriminatory tax measures over the longer term is also open to question. To a degree, discriminatory tax measures are accepted in the "real" world as one way by which provinces can attract a greater share of economic activity. Carried to the extreme, however, such "beggar thy neighbour" policies can only serve to invite retaliation. More often than not, nobody gains in the end from these policies, and everybody loses because of the resulting "balkanization" of the economy.

The Council consequently welcomes the initiative shown by several provincial governments in support of a Code of Conduct that, among other things, would involve forgoing, by mutual agreement, discriminatory taxation practices. At the same time, however, we consider it important that any such Code of Conduct should take account of the fact that the goals of discriminatory tax measures can be achieved equally well by other means. It is known, for example, that some of the discriminatory tax measures that the federal government has refused to administer on behalf of the provinces have their counterparts in expenditure programs of other provinces.

For this reason,

13 We recommend that provincial governments, when seeking agreement on tax measures in the Code of Conduct, take into account the similarity between the effects of discriminatory taxation practices and those of some expenditure programs and regulatory measures.

It would be misleading to lay blame for balkanization of the economy solely on the provinces. Concern should be expressed, too, about federal policies that affect the free flow of goods, capital, and labour in the economy. The chief examples in the case of federal tax policy are special investment and employment credits provided under the Income Tax Act in regions characterized by high and persistent unemployment levels and relatively sluggish growth. Other incentives administered under the Department of Regional Economic Expansion are designed to direct new private sector investment expenditures to the same regions through funding of investment in new infrastructure, such as roads, and through grants and loan guarantees to businesses prepared to undertake new capital investment in these regions. It has been suggested that the federal government agree to accept, as part of the Code of Conduct or otherwise, some constraints on its own actions in this regard.

The Council interprets this suggestion as a call for more careful consideration of the effects of these federal policies on the efficient functioning of the Canadian economy.

Tax Competition among Provinces

For the most part, the Council sees less cause for concern with respect to other forms of tax differences between provinces. We note that provinces usually tend to avoid excessive differentiation in basic taxes on factors of production that are mobile between jurisdictions. Nevertheless, some of the differences in taxation that have emerged in recent years may be viewed as reflecting a legitimate attempt by the provinces to implement distributional objectives. Some of this differentiation may also be viewed as an example of healthy rivalry between jurisdictions.

The Council realizes that the prospect of tax "competition" does worry provinces faced with the prospect that other jurisdictions can provide similar levels of public services with much lower degrees of tax effort. A related concern is that reductions in corporate taxation may be used by the more wealthy provinces to attract business to their jurisdictions. These

concerns have led to proposals to "federalize" the corporate income tax or at least to impose uniformity in provincial corporate tax rates.

The Council sees little merit in these proposals. They are, of course, unpalatable from the point of view of their implications for the autonomy of provincial governments. There is also the pragmatic fact that they would not work. The problems these proposals address arise because of differences in the financial capacities of provincial governments - differences that will remain a fact of life in Canada for some time. It would be useless to address some of the consequences of these differences in provincial financial capacities by attempting to impose uniformity in taxes. If wealthy provinces were determined to attract business away from other jurisdictions, they could just as easily do so by "expenditure competition" as by granting tax breaks to business.

FISCAL ARRANGEMENTS AND STABILIZATION POLICY

There are strong arguments for federal-provincial co-operation in stabilization policy. These were discussed in some detail in the Council's 1977 Report, Living Together.[3] Briefly stated, the provinces cannot contribute to the conduct of effective stabilization policy without the co-operation and support of federal fiscal and monetary authorities. The Government of Canada, on the other hand, would have to rely on a dangerously narrow range of policy instruments if it were forced to conduct stabilization policy without the support of the provinces. These restrictions would result either in stabilization policy not being pushed far enough or in opportunities not being seized for the selective application of policy to particular regions or particular economic activities.

There are obvious ties between the fiscal arrangements and stabilization policies. They are negotiated by the same people in the same forums, and both substantially influence the pattern of revenues and expenditures as between governments. These interrelationships are clearly important. The willingness to co-operate in one area of economic policy is naturally influenced by the degree of co-operation evidenced in others.

Of considerably more importance, however, is the practical question of whether or not the relative roles of the federal and provincial governments that have emerged out of the fiscal arrangements have reduced the effectiveness of stabilization policy in Canada. Particularly since the report of the Royal Commission on Taxation [the Carter Commission] in 1966,[4] there has been some concern that growing provincial fiscal power

could reduce the effectiveness of federal stabilization policy, either deliberately or because of the inherent destabilizing features of provincial-local finance.

Special studies undertaken in connection with this report and our own analysis lead to the conclusion that the effectiveness of stabilization measures has not been undermined by the shift that has taken place to date in fiscal resources and responsibilities from the federal to provincial governments. There are several reasons why. In the first place, provincial government growth has been essentially at the expense of the private sector, not the federal government. By replacing the inherently less stable private activity, provincial government growth has reduced the scope for economic fluctuation. Nor does the empirical evidence of the last 15 years in Canada support the argument that provincial and local government budgetary activity has been perverse. In other words, these budgets have not added significantly to demand during peak periods nor to decline in recession and, therefore, have not worked against stabilization measures at the federal level. Moreover, the main areas of provincial spending growth - education, hospital care, and medical care - generally do not follow such cyclical patterns and adjustments. Finally, changes in the structure of both taxes and expenditures at the federal level have, in fact, increased the built-in stability of the federal budget. These conclusions apply to stabilization issues arising from cyclical variations; structural adjustments raise other issues that have to be considered as specific cases.

Section 2 of the Fiscal Arrangements Act contains a specific provision related to stabilization. That section ensures that if provincial tax yields other than from resources decline for economic reasons, federal payments will be increased sufficiently to enable provincial services to be maintained at the level existing a year earlier. This provision has been a feature of the fiscal arrangements since the 1950s, although no payment has been made under it. Its chief effect may be to improve the credit rating of smaller provinces by providing a federal guarantee of cash flow. Thus, while supportive of economic stability and a feature of the arrangements worth maintaining, this provision is not an active instrument of economic stabilization.

Over the past several years, there have been a number of suggestions that provisions be made in the fiscal arrangements to allow for more active participation by provincial governments in the conduct of economic stabilization policy. The Carter Commission, for example, proposed that the federal government take steps to increase its transfers to the provinces during a

recession and to decrease them in times of excessive economic growth. Others have suggested that the federal government should be prepared to purchase bonds issued by the provinces at the prevailing federal interest rate in order to help finance expansionary provincial measures during periods of slow or declining economic growth.

On the basis of past experience, we do not believe that adoption of these suggested approaches is warranted. Our examination of the record indicates that, on balance, provincial governments have played a positive role in support of federal stabilization policy. In our view, any benefits that might be gained by taking steps to encourage greater provincial participation in the conduct of stabilization policy would be considerably outweighed by the additional measure of instability that would be added to the federal budget.

Most of these proposals for increasing provincial involvement in stabilization policy reflect a concern that the federal government's ability to continue to play a major role may have been undermined by the substantial shift that has taken place in the proportion of revenues and expenditures under the control of provincial governments. Notwithstanding this shift, our analysis indicates that the federal government continues to have at its disposal the tools needed to conduct stabilization policy effectively. A further major finding of our analysis is that a shift in the responsibility for the financing of the EPF program - for instance, by the federal government transferring tax room to the provincial governments in place of existing cash transfers - would have minimal implications for the conduct of stabilization policy. We conclude, therefore, that the issues of stabilization policy and of fiscal decentralization can be regarded as separate and unique.

THE POLITICS AND PROCESS OF THE FISCAL ARRANGEMENTS

The complex intergovernmental machinery established to undertake negotiation of the fiscal arrangements at five-year intervals is indicative of the high degree of interdependence among governments in Canada. While, in general, the provincial and federal governments have developed quite autonomous and independent roles in economic and social policy making, the programs under the fiscal arrangements have been achieved largely through a complex intergovernmental process characterized by consultation, co-operation, and compromise. In large part, this decision-making process reflects the considerable extent to which the programs themselves are subject to shared responsibilities in areas relating to taxation,

hospital care, medical services, postsecondary education, and the level of government services in general.

Democracy and Effectiveness in Decision Making

In examining the process of reviewing the fiscal arrangements, the Council analysed criticisms questioning the democratic nature and effectiveness of policy making. These criticisms are usually raised with respect to intergovernmental affairs in general, but we specifically applied them to the fiscal arrangements. In our view, the major problems relate to the level of openness and participation in the process, although the nature of our parliamentary system and of financial legislation must be taken into account when considering these problems.

To a considerable extent, the various committees established for the negotiation of intergovernmental arrangements meet behind closed doors. Traditionally, information has not always been made available in advance to legislative members, or the public at large, about the issues under negotiation; moreover, little or no opportunity has been provided for them to express their views on the matters in question, despite the fact that their interests may be vitally affected by the outcome. Furthermore, insufficient information has been made available on the actual working of the arrangements that have been arrived at through this process of closed negotiations; nor has there been as much opportunity provided as there might have been for legislative bodies, or the public, to review and comment on the resulting effects of such arrangements.

Federalism and the Quinquennial Review of the Fiscal Arrangements

The Council also examined how the reviews of the fiscal arrangements affected the respective responsibilities and powers of governments in Canadian federalism. We did not feel it appropriate to make recommendations in this area, because broad political judgments are required, as well as a general appreciation of the workings of the Canadian state, both of which are beyond the Council's responsibilities. Nevertheless, the conclusion was reached that it was desirable to raise these issues for public discussion, especially since in the current negotiations the federal government has linked the notion of a "fiscal imbalance" with the concept of a "political imbalance." In June 1981, Finance Minister MacEachen argued before the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements that the fiscal strength of the provinces as a whole had substantially increased their political leverage.

While the Council does not take any broad position on the appropriate roles or balance of power among governments in Canada, our analysis of the intergovernmental process involved in the review of the fiscal arrangements provides a basis for some comments on the issue. The main point to be made is that governments function in a complex, economic and social milieu that encourages a high degree of interdependence and does not easily permit the classification of roles and responsibilities without overlap and ambiguity. The formal powers of governments in a federal state may be initially designed in a constitution, but, after that, the political and legal process actively redefines the powers to be held by governments in response to economic and social changes.

The review of the fiscal arrangements displays this pattern of overlapping, ambiguity, and interdependence regarding the respective responsibilities of the two levels of government. Despite the considerable legal powers that the federal government has under the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, an elaborate system of intergovernmental co-operation and consultation is in place. In strictly legal terms, the federal government can act unilaterally to change the programs in the fiscal arrangements; in practice, however, no one level of government has yet dominated the other because each comes to the table armed with real bargaining power.

Reform of the Process

Looking to the future and possible reform of the process, the establishment of the federal Parliamentary Task Force prior to the current negotiations on the fiscal arrangements represented an innovative means of increasing openness and public participation. For the first time in Canadian history, a public forum was provided through meetings of the Task Force across the country for discussion and review of the fiscal arrangements by affected groups and individuals. Members of Parliament themselves were also given considerable opportunity to express their own conclusions in advance of the negotiations among governments.

As a step towards resolving the problems of the level of openness and participation in the reviews of the fiscal arrangements, we believe that the federal and provincial governments should make use of committees similar in nature to the Task Force. Either existing standing committees or specially created task forces should be charged with the responsibility of studying in advance all intergovernmental arrangements that are to become the subject of negotiations

during the review of the fiscal arrangements. These committees should have the power to hear the views of all concerned groups.

Accordingly,

14 **We recommend that Parliament and legislatures in Canada empower committees to review and monitor issues of importance to the fiscal arrangements and to consider the views of representative groups in advance of each quinquennial review.**

Another important step towards a more open review involves the availability of information. It is the Council's belief that the technical information prepared by bureaucrats as background for negotiation of the fiscal arrangements should be accessible to the committees proposed above and to the public. We recognize that the negotiations require a certain degree of confidentiality with respect to the policies and positions of each government if true bargaining is to occur. By the same token, however, as a general rule we consider that much of the technical information can, and should, be made available.

Therefore,

15 **We recommend that federal and provincial governments ensure that sufficient information is forthcoming to Parliament, provincial legislatures, their committees, as well as representative groups in order that they have a full opportunity to review the fiscal arrangements both before and after negotiations. Partially to fulfill the obligations of this recommendation, the Council urges the federal and provincial Finance Ministers to report to their respective legislatures and committees before and after the negotiations.**

Having suggested some rather modest adjustments to the process, the Economic Council believes that the fiscal arrangements should continue to be reviewed regularly in a way that is effective but yet in a spirit consistent with parliamentary democracy and federalism in Canada.

DISSENT AND COMMENT BY PIERRE LORTIE

DISSENT ON ESTABLISHED PROGRAMS FINANCING

My dissent concerns Recommendations 6, 7, and 12 in the section of the report on Established Programs Financing. In my view, these recommendations are based on an approach to the organization of the Canadian polity that is at odds with Canada's constitutional framework and with the views of many Canadians as to the structure of the system that will best deliver these programs.

At the outset, I should state that these recommendations by the Council are simply not warranted. First, they do not derive from the research findings presented in the chapters describing the Council's research and methodology (to be published in February). Second, they amount to a complete reversal of the agreements that the federal government reached with the provinces in 1977. It should be recalled that on June 14, 1976, Prime Minister Trudeau proposed to replace the existing cost-sharing arrangements for medical care, hospital insurance, and postsecondary education by a new system, Established Programs Financing. This system had the advantage that contributions would no longer be tied to provincial expenditures. The rationale behind these proposals arose from a desire to better match the revenues of each level of government with the primary responsibilities assigned to each level under the Constitution of Canada.

In my view, nothing has happened during the ensuing period that would call into question this fundamental policy direction. In fact, the evidence contained in the Council's research indicates that Established Programs Financing has worked well. With respect to the options available, I would have preferred consideration of further substantial disentanglement of federal-provincial programs. This disentanglement could be achieved through replacement of some of the present cash payments by an unconditional transfer of tax points, supplemented by adjustments in the Equalization Program.

Many arguments have been put forward against such a course of action. For example, it is often asserted that the federal government cannot possibly transfer more resources to the provinces. In my opinion, these arguments are not well founded. The federal government has already agreed to support and finance these programs, which are under the jurisdiction of the provinces. As a result, the federal revenues are earmarked and are no longer available for other federal programs. The issue at stake, therefore, is not the amount of resources but the method used to effect the transfer.

In considering this latter issue, I firmly believe that the accountability of governments is enhanced when each level is forced to raise the taxes required to support its own expenditure programs. This is one of the obvious merits of the 1977 agreement and it should not be destroyed. To the contrary, I think that accountability of governments in Canada would be improved if further disentanglement was pursued.

The argument that the federal government needs these resources to conduct a more efficient macro-economic policy is really a delusion. Federal initiative in macro-economic policy areas requires the ability to shift resources; only then does it have effect at the margin. Here again, since the resources are already committed to the programs under Established Programs Financing, they are locked in and in the short term are no longer available for other federal policies. One could even make a good argument that the federal government has been overly stubborn in treating these expenditures as its own resources and in promising to provide a high level of payments to the provinces. In the past, this stubbornness has limited the federal government's ability to conduct other national policies and has unnecessarily raised tensions within the Canadian federation.

It should be stressed that being strong is not synonymous with being "fat" or "inflated." Yet, that is effectively the stance of those who state that the federal government needs to collect the taxes required to finance Established Programs Financing.

A second argument supporting the federal government's role in Established Programs Financing stems from the need to ensure the accountability of the federal government. This argument in my view is also fallacious. First, the involvement of the federal government in programs under these areas of jurisdiction was, and still is, based on the "spending power" (that is, the assumed power of the federal government to make payments to persons, institutions, or governments for purposes and matters over which it does not necessarily have the power to legislate).

It is incorrect, however, to assert that the federal government must define policies in areas where it does not have the power to legislate once it has entered those fields using its spending power. Such a reasoning is circular. In the case of Established Programs Financing, the real answer to this problem of accountability is that there should be further disentanglement of the responsibilities of each level of government, not blurring further the responsabilities of respective governments.

The issue of national standards should also be addressed when considering Established Programs Financing. In current debates, this issue is often overblown. The fact that the federal government shares in the financing of some major programs does not mean that national standards will necessarily emerge. As a matter of fact, no agreement on national standards has yet been reached on Established Programs Financing, whereas national standards exist for the Canada and Quebec Pension Plans. Thus, it is a fallacy to state that the establishment of national standards derives naturally or automatically from funding. Such standards can only be achieved if there exist a political will and a thorough understanding of the policy issues and their implications. When these conditions exist, it is safe to assert that the federal government will have enough leverage to secure an agreement on reasonable national standards.

I should also mention that it is my belief that many of the federal papers and documents published on Established Programs Financing contain many naive views of the management of complex programs and institutions. We all know from past experience with the Post Office and the Canada unemployment insurance system that the federal government is not a particularly good example of how complex programs or institutions should be managed. Moreover, the idea that the federal government should finance infrastructures while the provinces should finance the on-going administrative costs (such as recommended by the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements)[1] is clearly unwarranted. This idea clearly contradicts any well-understood concept of accountability. If the provinces opt for maintaining tight financial reins on the growth of expenditures for these programs, for example, it is untenable for the federal government to encourage greater expenditures at the same time.

The major problem facing management of the programs under Established Programs Financing is how to enhance productivity and efficiency in the delivery of these services in a way that will better serve the needs of Canadians. This requires strong management on the part of provincial authorities. Parliament

and the federal government should not destroy or undermine these efforts by becoming the spokesmen for certain special interest groups. In my view, this will be the outcome of the Economic Council's recommendation asking for annual debate and ministerial statements on the management of these programs in the House of Commons.

The Council report also states that better comparative data and information are required to permit a greater understanding of these programs. This data base would allow for more informed judgment on the efficacy of the program's management and for more enlightened policy debate. I agree with this view of the Council. I submit, however, that the stated objectives would be better served if this task were to be performed by a "neutral" agency rather than by a policy department. There are too many risks that a policy department would produce a data base that fit its own objectives instead of one that could be used by all concerned. In turn, this will destroy many advantages accruing from a national data bank and will rapidly turn the discussion to an acrimonious debate.

Comment on Discriminatory Taxation Measures

The ideals expressed in the Council report on tax harmonization are laudable; the analysis, however, presents a truncated view of the effects of provincial and federal policies on the redistribution of government activities across this country. The analysis ignores how the overall impact of federal tax policy decisions can have an inordinate effect on one area of the country at the expense of other areas.

Examples applicable to all provinces can be found to demonstrate the way that federal taxation measures can affect one province differently than others. A recent report by Quebec's Department of Finance[2] shows that the effect of the federal tax structure in terms of personal income, considering the socio-demographic characteristics of the Quebec population, results in more burdens for Quebec residents than for residents of other provinces. Another example often cited is the federal Registered Home Ownership Savings Plan, which does not take into account the habits of Quebec residents. One could also point to the tax treatment of oil and gas expenditures and the geographical impact of these measures, especially in comparison with the less favourable tax treatment of investment in the manufacturing sector.

By definition, economic policies are meant to discriminate. It is misleading to single out one type of policy as

unacceptable, while forgetting the overall impact of national policies developed by the federal government. The relevant issue is the setting of policy objectives and the selection of the various instruments used to achieve them.

NOTES

Chapter 1

1 Report of the Royal Commission on Dominion-Provincial Relations [The Rowell-Sirois Commission] (Ottawa: King's Printer, 1940).

2 The Honourable Allan MacEachen [Deputy Prime Minister and Minister of Finance], Federal-Provincial Fiscal Arrangements in the Eighties, Submission to the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements (Ottawa: Department of Finance, April 1981).

3 Calculations were based upon comparison of the estimated federal deficit in 1981 under the base case with the federal deficit at "potential" under the "smooth productivity growth" scenario. Both estimates were supplied by the CANDIDE Model 2.0 for the Economic Council's Eighteenth Annual Review.

4 Department of Finance, Economic Review (Ottawa: Supply and Services Canada, April 1980), Table I1-2.

5 According to Economic Council of Canada calculations based upon projections from CANDIDE Model 2.0.

Chapter 11

1 Report of the Royal Commission on Health Services [the Hall Commission], 2 volumes (Ottawa: Queen's Printer, 1965).

2 This and all other quotations in this chapter were from the Honourable Allan MacEachen [Deputy Prime Minister and Minister of Finance], Federal-Provincial Fiscal Arrangements in the Eighties, a submission to the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements (Ottawa: Department of Finance, April 1981).

3 Economic Council of Canada, Living Together (Ottawa: Supply and Services Canada, 1977).

4 Report of the Royal Commission on Taxation [the Carter Commission], 2 volumes (Ottawa: Queen's Printer, 1966).

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1 Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, Fiscal Federalism in Canada (Ottawa: Supply and Services Canada, August 1981).

2 Quebec Department of Finance, Les préférences fiscales du régime d'imposition au Canada (Quebec: Government of Quebec, October 1981).